IN THE

United State Court of Appeals

FOR THE NINTH CIRCUIT

MEYER FELDMAN,

Appellant,

vs.

WILSON B. WOOD,
District Director of Internal
Revenue for Arizona,

Appellee.

No. 18,908

On Appeal From the Judgment of the United States District Court for the District of Arizona

BRIEF FOR THE APPELLANT

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OPINION BELOW

The findings of fact and conclusion of law of the District Court (R.I. 14-18) are reported in 1963 - 1 U.S.T.C. 9428.

JURISDICTION

This suit was commenced against the District Director of Internal Revenue for Arizona based upon his denial of a timely filed claim for refund. (R.I. 8) The judgment appealed from was entered April 11, 1963 (R.I. 20), and the notice of appeal (R.I. 21), was filed June 10, 1963. The jurisdiction of this Court rests on 28 U.S.C. 1291.

QUESTION PRESENTED

Whether taxpayer, whose lessee demolished valuable improvements situated on the leased property, is entitled to claim a deduction under Section 165 or 167 of the Internal Revenue Code of 1954 for cost basis of such demolished improvements.

STATUTES AND REGULATIONS INVOLVED

Appendix A *infra*.

STATEMENT

Taxpayer, in 1950, purchased business property in downtown Tucson, Arizona. The property was improved with a residential court and warehouse. Taxpayer moved the residential court to other property owned by him, and continued to rent the warehouse under the same terms as the previous owner. (R.II. 51.) On June 8, 1951, taxpayer entered into a five-year lease (with a five-year option), to lease the property (excluding the warehouse) to M. V. and Geneva R. Blakely. The Blakely lease required taxpayer to construct a filling station (R.I. 12), which he did. (R.II. 19-20.)

Taxpayer's wife died in 1953 and the subject property acquired a new cost basis as follows, (R.I. 9):

Buildings	-	$55,000.00; and
Land	-	$45,000.00.

On June 1, 1955, taxpayer entered into a 99-year lease of all of the subject property with Laurence D. and Pauline Mayer. (R.I. 9.) The Mayers, in August of 1957, demolished the warehouse and filling station, which at the time had an unrecovered cost basis of $47,300.00. (R.I. 9.)

Taxpayer filed his 1957 individual Federal income tax return, claiming a depreciation deduction of $48,400.00 for the unrecovered cost basis of the warehouse

and filling station. (The $1,100.00 difference results from allowable but unclaimed depreciation). Appellee's examining revenue agent disallowed the claimed deduction, and based upon this disallowance (and minor adjustments not here in issue), Appellee assessed against taxpayer $29,558.32 in tax deficiencies and interest for calendar year 1957. (R.I. 8.) Taxpayer paid the above sum to Appellee on August 8, 1961, and thereafter timely filed a claim for refund and upon its denial this lawsuit. (R.I. 8.)

Taxpayer in his claim for refund made the following contentions, (R.I. 4-5):

(1) He suffered a tax deductible loss in the claimed amount under Section 165 of the Internal Revenue Code of 1954, for the demolition by lessee, Mayer, of his warehouse and filling station.

(2) He was entitled to a depreciation deduction in the claimed amount under Section 167 of the Internal Revenue Code of 1954, for the retirement from useful life during 1957, of the subject buildings.

SPECIFICATION OF ERRORS RELIED ON

1. The District Court erred in finding and concluding that taxpayer suffered no loss within the meaning of Section 165 of the Internal Revenue Code, when his lessee demolished buildings with an adjusted cost basis of $47,300.00.

2. Regulation 1.165-3(b)(2) denies a loss when the demolition is pursuant to the *requirements* of a lease. Taxpayer's lease permitted demolition, it did not *require* it. The District Court erred when it failed to apply this Regulation to facts of the case.

3. The District Court erred in concluding that Treasury Regulations 1.165-3(b)(2), though promul-

gated by the Commissioner of Internal Revenue, were not binding on the Government in this case.

4. The District Court erred in finding and concluding that taxpayer was not entitled to a depreciation deduction within the meaning of Section 167 of the Internal Revenue Code when the useful life of depreciable assets with an adjusted cost basis of $47,-300.00 was suddenly terminated.

5. The District Court erred in finding and concluding that Treasury Regulation 1.167(a)-8, allowing a deduction for the abnormal retirement of a depreciable asset, had no application to the sudden redetermination of useful life of taxpayer's depreciable assets through his lessee's demolition of such assets.

6. The District Court erred in finding that taxpayer had failed to meet his burden of proving a loss deduction in calendar year 1957.

7. The District Court erred in finding that taxpayer had failed to meet his burden of proving a depreciation deduction in calendar year 1957.

SUMMARY OF ARGUMENT

Treasury Regulation 1.165 interpreting the 1954 Code, allows a taxpayer a loss deduction for the demolition of buildings on income producing property where the intent to demolish is formed subsequent to the date of acquisition. For property under lease the deduction is denied only where the demolition is pursuant to the *requirements* of the lease. Taxpayer's lessee, in 1957, demolished buildings with an unrecovered cost basis to taxpayer of $47,300.00. Taxpayer acquired the property in 1950, and leased it in 1955. The lease did not require demolition, but permitted it.

Treasury Regulation 1.167 interpreting the 1954 Code, allows a loss (or gain) for the permanent with-

drawal of depreciable property from use in a trade or business by "abnormal retirement." Abnormal retirement means the withdrawal of the asset for a cause not contemplated when setting the applicable depreciation rate. Taxpayer's situation here is precisely within the terms of this Regulation.

ARGUMENT

I.

THE RECORD ESTABLISHES THAT TAXPAYER WAS ENTITLED TO A DEMOLITION LOSS FOR CALENDAR YEAR 1957 IN THE SUM OF $47,300.00 UNDER THE TERMS OF SECTION 165 OF THE INTERNAL REVENUE CODE AND TREASURY REGULATIONS 1.165-3, PROMULGATED PURSUANT TO THAT SECTION AND CONSISTENT THEREWITH.

Taxpayer-Appellant acquired the subject property in 1950, along with a warehouse and rental units. In the purchase of the property, he executed two mortgages, in each of which there was a provision allowing him to remove existing buildings. (R.I. 11.) Taxpayer removed the rental units, but continued to rent the warehouse. He had intended to remove the rental units when he purchased the property, and he had intended to continue to rent the warehouse. (R.II. 52.) The rental units were removed, and their removal is not in issue here. The issue here is the demolition of the warehouse and a subsequently constructed filling station. The demolition took place some seven years after the date of purchase of the property.

The subject filling station was not constructed until after taxpayer had acquired the property, and it

was, from the time of construction, subject to the five-year Blakely lease and the five-year renewal option of such lease. (R.I. 12.) The warehouse was separately rented at the time of acquisition, and taxpayer continued to rent it to the then tenant, and others, for a period of seven years. (R.II. 52.) Treasury Regulations 1.165-3(b), Appendix A, *infra*, provides in part:

> (1) "* * * the loss incurred in a trade or business in a transaction entered into for profit and arising from a demolition of old buildings shall be allowed as a deduction under 165(a) *if the demolition occurs as a result of a plan formed subsequent to the acquisition of the building demolished.* * * * " (underscoring supplied).

This Regulation and preceding Rulings represent the Appellee's recognition of a long line of cases. See I.T. 3311, 1939 - 2 Cum. Bull. 206; *Union Bed & Spring Co. v. Commissioner*, 39 F.2d 383 (C.A. 7th) reversing 9 BTA 352; *Panhandle State Bank v. Commissioner*, 39 T.C. 813; *George S. Gaylord v. Commissioner*, 3 T.C 281; aff'd on other grounds, 153 F.2d 408 (C.A. 9th); *Wearley v. U.S.*, 32 A.F.T.R. 1761 (D.C. N.D. Ohio); *Hotel McAllister, Inc. v. U.S.*, 3 Fed. Supp. 533 (D.C. Fla.).

The buildings in question were demolished by the subsequent lessee, Mayer, in 1957, and they had been held up to that time in taxpayer's trade or business. (R.I. 9.) The only remaining question is whether taxpayer is within the exclusion to the above Regulation which provides 1.165-3(b)(2), Appendix A, *infra*:

> "If a lessor or lessee of real property demolishes the buildings thereon pursuant to the requirements of a lease * * * no deduction shall be allowed. * * *"

The lease in question provides, (R.I. 9; stip. Ex. C):

"11. Lessee shall have the right to remove and demolish any or all existing improvements on the demised premises for the purpose of creating additional parking area, adding improvements, or providing ingress and egress to and from Toole Avenue, * * *."

This language seems clear. Lessee, Mayer, may demolish – he is not required to do so. The permissive nature of lessee Mayer's rights with regard to the lease, is again emphasized in paragraph 22 of the lease. (R.I. 9; stip. Ex. C):

"22. The lessee may, at any time or times during the term hereof, and at his own cost and expense, make any alterations, rebuildings, replacement, changes, additions and improvements to the demised premises * * *."

The term "require" or "requirement" has a common and definite meaning to lawyers and to laymen alike.

Black's Law Dictionary (Third Ed.):

Require: To direct, order, demand, instruct, command, claim, compel, exact. /Citations/

Webster's Third New International Dictionary, 1961 Ed.:

Requirement: * * * something required.
a: Something that is wanted or needed: *Necessity.*
b: Something called for or demanded: a requisite or essential condition. * * *

In addition, the term "require" or "requirement" has been defined in innumerable cases. A few of these are:

The word require means to demand; to ask as of right and by authority; to insist on having; to exact. *Federal Lead Co. v. Swyers,* 161 F. 687, 692.

Require is synonymous with demand. *U.S. v. Armour & Co., et al.,* 142 F. 808, 822.

Requirement is defined as being that which is required: An imperative or authoritative command. *Ohio Automotive Sprinkler Co. v. Fender,* 141 N.E. 269, 275; 108 Ohio St. 149.

To require means to demand. *State, ex. rel. Frohmiller,* 124 P.2d 768, 773; 59 Ariz. 184; see also *Industrial Commission v. Frohmiller,* 140 P.2d 219, 222; 60 Ariz. 464.

The normal meaning of the word require means to demand: to claim as by right and authority; to exact. *Harwood v. Dysart Consolidated School* Dist., 21 N.W.2d 334, 336; 237 Iowa 133; *Newcomb v. Victory Ins. Co.,* 155 P.2d 456, 458; 159 Kan. 403.

Taxpayer, here, could not compel or demand any demolition. Under the terms of this lease, the lessee could have been in possession for 99 years and not demolished anything. Requirement may be used in the permissive sense — such as a contract which provides that "the lessee may cut sufficient timber to meet his requirements." It is clear, however, that the Commissioner in the instant case did not use the word in the permissive sense. His proposed Regulation (Proposed January 3, 1956, withdrawn and proposed again October 8, 1959), read as follows, 1.165-3(2)(d):

> "(d) *Buildings demolished to obtain lease.* If pursuant to the *terms* of a lease, the lessor of real property demolishes buildings situated thereon, no deduction shall be allowed to the lessor under 165(a) on account of the demolition of the old buildings. Likewise, if, pursuant to the *terms* of a lease, the lessee of real property demolishes the buildings, no deduction shall be allowed to the lessor * * *." (underscoring supplied).
>
> The use of the word "terms" of course, would be

permissive and if the Commissioner had enacted his final regulation using "terms," we would have little to argue. However, the Commissioner, after inviting comments on the proposed Regulation and after months and months of careful consideration, changed the word "terms" to "requirements." There is no other fair conclusion to draw from the Commissioner's voluntary changing of the wording of this Regulation, but that it was his intent that the loss should be excluded when demolition is compelled or required by the lease, but not when it was merely permitted. Fortunately, we do not need to speculate on the Government's intention in this regard, for the Commissioner invited comments on his October 8, 1959, proposed Regulation.

On October 22, 1959, taxpayer's accountants forwarded the following comment to the Commissioner on his proposed Regulation, (R.I. 10):

"Commissioner of Internal Revenue
Washington, D.C.

Subject: *Comment on Proposed Regulations* 1.165-3(d)

Sir:

Pursuant to the Administrative Procedure Act of 1946, we hereby urge, on behalf of our clients and in the interests of administrative clarity, that the proposed regulations 1.165-3(d) (published 10/8/59) be reworded to read substantially as follows:

> If, pursuant to the *requirements* of a lease, the lessor of real property demolishes buildings situated thereon, no deducton shall be allowed to the lessor under section 165(a) on account of the demolition of the old buildings. Likewise, if, pursuant to the *requirements* of a lease the lessee of real property demolishes the buildings, no deduction shall be allowed to the lessor. However, the adjusted basis of the demolished building shall

be considered as a part of the cost of the lease to be amortized over the term thereof.

The regulation as published in the Federal Register, has the word *terms* where we have above inserted *requirements.*

ARGUMENT

A long line of cases (of which the most recent is *Estate of Clara Nickoll,* 32TC132) has held that where buildings are demolished as a condition of obtaining a lease, the unrecovered cost of such buildings is in reality part of the cost of the lease so obtained. The proposed regulation, due to the possible vagueness of meaning of "pursuant to the terms" could conceivably extend this rule to almost all demolitions.

1. Almost all commercial property is occupied under some form of lease. If, during the period of a lease, a demolition takes place, then such demolition either violates the lease or is presumably "pursuant to the lease," at least as modified at that point by the parties. If the demolition violated the lease, the demolition could be enjoined by the injured party, in which event it would never occur. If it does not violate the lease, it must be "pursuant to the terms" of the lease.

2. It is not uncommon for long term leases to contain clauses whereby the lessee is permitted to demolish any improvements. If a piece of property was leased on a ninety-nine year lease, for example, the lessee would normally, as a matter of routine, be granted this right – which might be exercised in five, or fifteen, or fifty years. Such a clause would be for the purpose of protecting the lessee, and would not evidence any specific intent of the parties to demolish at any specific time, or even at all. It would normally not be a factor in determining the rental terms. As to this point, see the attached letter from Dr. James Chase. Since the year 1950, Dr. Chase has been regularly listed in Who's Who, and also in American Man of Science. Please note attached summary of his professional status. In our opinion, he is a highly quali-

fied expert in this field, with over twenty years of teaching and consulting experience.

3. The proposed regulation seeks to disallow a loss where the parties, at the time of entering into the lease and as a part of the consideration for entering into the lease, contemplate and contract to have such demolition take place. In this sense, the proposed regulation is within the spirit of I.T.3311, CB206, 1939-2. There the position was set forth that if specific intent to demolish was present at the time of acquiring the property, the loss should be disallowed. This reasoning is reiterated in proposed Regulation 1.165-3(b). But this reasoning is best exemplified in this area if the proposed wording is changed to "pursuant to the requirements of a lease," rather than "pursuant to the terms of a lease," since "terms" could be merely permissive as well as mandatory, and could be implied as well as explicit.

Respectfully submitted,

/s/ Jacob Smith
Jacob Smith, C.P.A.
Enrolled to practice before the
Treasury Department."

It should be noted that taxpayer's representatives pointed out to the Commissioner that the use of the phrase "pursuant to the terms of a lease" could only mean permissive demolition and that the net practical effect of this language would be to deny a demolition loss in any long term lease. The comment further notes that a long term lease almost of necessity permits demolition but it does not of necessity compel it.

The Commissioner not only acknowledged the comment, but changed the Regulation and expressed his appreciation for the suggestion, (R.I. 10):

"Goldstein, Kramer and Smith
2221 East Broadway
Tucson, Arizona

Nov. 20, 1959

Attention: Mr. Jacob Smith

Gentlemen:

This will acknowledge your letter dated October 22, 1959, commenting on the provisions of proposed regulations under the internal revenue law which were published in the Federal Register for Thursday, October 8, 1959.

Your comments are appreciated and will be given careful consideration before the final regulations are promulgated.

Very truly yours,

(signed)

Chief
Regulations Program Section"

"Goldstein, Kramer and Smith
2221 East Broadway
Tucson, Arizona

January 15, 1960

Attention: Mr. Jacob Smith

Gentlemen:

This is in further reply to your letter of October 22, 1959, regarding the proposed regulations issued under section 165 of the Internal Revenue Code of 1954, relating to deduction for losses.

The final regulations on deduction for losses have been promulgated as Treasury Decision 6445. This Treasury Decision will be published in the issue of the Federal Register for Saturday, January 16, 1960. It reflects a number of changes from the proposed regulations previously published.

Your interest in submitting comments on the proposed regulations is appreciated.

Very truly yours,

(signed)

Director
Technical Planning Division"

The Commissioner made this change with full knowledge of the comment and his prior rulings denying a deduction when demolition is compelled. The comment pointed out the theory behind these rulings was that when demolition is required it is usually negotiated for by the parties and becomes part of the consideration for the lease, (accountants' letter of October 22, 1959, *supra*).

We do not say that these events result in a legal or equitable estoppel of the Commission, but we do say he cannot now claim he did not intend the mandatory or compelling meaning of the term "requirement." He cannot now say that "require" really does

not mean "require." If he truly intended that the regulation should be interpreted as he now contends, then he should have stayed with his original language.

As previously noted in this brief (p. 8-13), the Commissioner gave careful and unhurried consideration to this Regulation before its final adoption. It is submitted that he is bound by his Regulation. The general rule as to administrative construction applied to the Commissioner, as well as other administrative agencies, that is:

> The administrative interpretation does not necessarily control the court's decision as to the proper construction of a statute, but generally or in particular circumstances it is given great weight and has a very persuasive influence, and may actually be regarded by the court as the controlling factor, since in doubtful cases there is an inclination to adopt the administrative construction which in any event will not be disturbed except for very cogent and persuasive reasons and a clear conviction of error. *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (must be sustained unless unreasonable and plainly inconsistent with the statute); *United States v. Leslie Salt Co.*, 350 U.S. 383, 389 (* * * the Treasury's interpretations of it are entitled to great weight); *White v. Winchester Country Club*, 315 U.S. 32, 41 (* * * they are entitled to serious consideration * * *); *United States v. Wyoming*, 331 U.S. 440; *Lucas v. American Code Co.*, 280 U.S. 445.

We do not believe the Government can contend that because the events in question took place prior to its adoption, this Regulation has no application to the present case: Section 7805(b) of the Internal Revenue Code (Appendix A, *infra*) provides in part:

"Sec. 7805 *Rules and Regulations*

* * *

"(b) Retroactivity of Regulations and Rulings.—The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the Internal Revenue laws shall be applied without retroactive effect."

Congress has by this statute given to the Commissioner an election. He may elect to specifically provide that a Regulation shall not be applied retroactively. He has not done so in the instant case and he is bound by his choice. No other rule could prevail, for if this were not so, there would be nothing to prevent Government counsel (where it suited the revenue) from arguing for example, in a Texas Federal District Court, that this Regulation has retroactive effect.

It should also be noted that while an administrative agency may amend or rescind its rules and regulations, so long as a rule or Regulation remains in force and without change, the agency is as much bound by such rule as the public to whom it is directed. The Regulation may not be ignored by the agency or suspended in a particular case. *Columbia Broadcasting Co. v. U.S.*, 316 U.S. 407; *Farmers Co-op v. Commissioner,* 288 F.2d 315 (C.A. 8th); *American Broadcasting Co. v. Federal Communications Commission,* 179 F.2d 437 (C.A. D.C.); 165 ALR 816.

The Mayer lease provided that some time during its ninety-nine ear term, the lessee would construct improvements of not less than $75,000.00. (R.I. 9.) From this, the Government may attempt to argue that demolition was implied. Outside of the fact that "implied" demolition could not under any circumstances be construed to be "required" demolition, the physical char-

acteristics of the property in question would have allowed lessee, Mayer, to construct a $75,000.00 improvement, or for that matter a $750,000.00 improvement, without disturbing any of the existing structures, (R.II., Ex. 1 & 2), and, the Court took judicial notice of this fact. (R.II. 27.)

The Government in seeking to avoid its present Regulation, relies on *Young* v. *Commissioner,* 59 F.2d 691 C.A. 9th), and *Blumenfeld Enterprises, Inc.* v. *Commissioner,* 23 T.C. 665, aff'd per curiam 232 F.2d 396 (C.A. 9th). These cases were decided under Regulations which did not specifically cover the lessor-lessee situation. In addition they involved significant factual differences and as the Court states in *Young,* "Each case is left to be judged on its own facts." In *Young,* the 99 year lease required the erection of a business building which in turn *required* demolition. The lease of existing buildings and the demolition occurred in the same year and it is clear that this immediate demolition was part of the consideration for the lease and had a direct relationship to the rental rate. The Court stated (59 F.2d 691 at 692 and 693):

> " * * * On the other hand, where he finds its advantageous to remove substantial buildings in order *to secure a lease* which will result in his having erected on his property a new building, without money outlay on his part for its construction, and to have assured a large rental income for a long term of years, it would seem just and reasonable that the value of the buildings removed be charged as a contribution to the cost of securing his lease, and as a part of the investment then made for that purpose."
> (emphasis supplied.)

In the instant case, demolition was not implicitly or explicitly required, and did not in fact occur until

over two years after the lease agreement. While demolition was permitted in the Mayer lease, there is no showing that it was part of the consideration or affected the rental rate. In addition the Court in *Young* assumed the lease had a pecuniary advantage and benefit to the lessor. This was not true of the Mayer lease.

The facts in *Blumenfeld* differ significantly from the instant case. The lease involved a theater building, but it also specifically required the building to be remodeled and the premises used for parking. The lessee was unable to get the San Francisco authorities to approve his remodeling plans. The items they required raised the cost to such a level that demolition of the building and use of the land for surface parking seemed more economical. Therefore *prior* to the effective date of the lease, a letter contract was entered into. This agreement required lessee to demolish the building, and demoltion actually took place immediately thereafter. The contract further provided as follows:

(23 T.C. 665, 667):

"5. In the event the Purchaser does not conclude the purchase of the property within one (1) year, the $25,000.00 mentioned under #2 above shall remain with the Seller as additional lease deposit under that certain lease dated the 6th day of October, 1949, between Blumenfeld Enterprises, Inc., as lessors, and Harry Morofsky, as lessee, and shall be deducted from rentals at the end of the lease term. In consideration of this additional lease deposit, the lessors grant to the lessee permission to demolish the rear portion of the premises (theater building) for the purposes conforming to said lease and further provided the lessee shall furnish to the lessor modified plans showing the proposed basement and ground floor development and shall secure from the lessors written permission for said development. All of the cost of demolishing and

improving shall be at the lessee's sole cost and expense."

It is clear from this agreement that immediate demolition was contemplated and that lessor negotiated for, and received compensation for such demolition. The Court states, 23 T.C. 665, 671:

> "* * * To be sure, the demolition of the theater building was not contemplated at the time of the execution of the agreement of October 6, 1949, but, prior to the commencement of the lease (May 1, 1950), it has become abundantly clear that the entire purpose of the lease would be defeated unless the building were demolished. * * * "

If *Blumenfeld* is viewed in its practical aspect — which is that of a sale — with demolition contemplated at the time of the sale, it followed under the Regulations in effect then (Reg. 111, Sec. 29.23(e)-2 and would also follow under present Regulations 1.165-3(a)) that no deduction is allowable for the latter Regulation states:

> (1) " * * * the following rule shall apply when, in the course of a trade or business . . . real property is purchased with the intention of demolishing immediately or subsequently the buildings situated thereon: No deduction shall be allowed under Section 165(a) * * *."

These are not the facts of the instant case.

In *Blumenfeld*, it is further stated (23 T.C. 665, 671):

> "Finally, the deduction must be disallowed for the reason that the removal of a building in connection with obtaining a lease on the property is regarded as part of the cost of obtaining the lease. (citing cases)"

This rule can have no application to this taxpayer since, under his lease, the removal was not connected

with obtaining the lease, and in fact, under the terms of the lease, removal might never occur.

II

THE RECORD ESTABLISHES THAT IN ANY EVENT TAXPAYER WAS ENTITLED TO A DEPRECIATION DEDUCTION IN THE SUM OF $47,300.00 UNDER THE TERMS OF SECTION 167 OF THE INTERNAL REVENUE CODE AND TREASURY REGULATIONS 1.167(a) FOR THE ABNORMAL RETIREMENT OF DEPRECIABLE ASSETS DURING 1957.

Treasury Regulations 1.167(a)-8(a)(3) (Appendix A, *infra*) allows a loss deduction for the abnormal retirement of an asset.

Section 1.167(a)-8(b) of the same Regulation defines abnormal retirement. A retirement will be considered normal unless the taxpayer shows that the withdrawal was due to a course not contemplated in setting the applicable depreciation rate. Stated positively the Regulation further states that a retirement may be abnormal if the asset is withdrawn at a time earlier than the normal range of years taken into consideration in fixing the depreciation rate.

The applicable depreciation rate for these buildings was set in 1953 at a rate based upon a 25 year life. (R.I. 8-9.) ($55,000.00 × 4% = $2,200.00 per year for 25 years). In 1953 the property was subject to the 1951 Blakely lease which had three years to run on the original lease, and five years on the option. (R.I. 12.) The Blakely lease did not contain a demolition clause or any other clause contemplating an early retirement of the leased buildings. The 25 year life was within the normal range for this type of building. *H. K. Jackson* v. *Commissioner,* 20 T.C.M. 1126; *J. D. O'Connor* v.

Commissioner, 13 T.C.M. 623; *Missouri State Life Ins. Co.* v. *Commissioner,* 29 BTA 401. The fact that Mayer, under a 99-year lease signed in 1955, might demolish or suddenly terminate the useful life of these buildings, could not have been contemplated by anyone in 1953.

The useful life of these buildings on January 1, 1957, was 21 years. The useful life of these buildings on December 31, 1957, was zero. The assets were withdrawn for a cause not contemplated in setting the rate any earlier than the normal range of years contemplated in fixing the rate. The retirement was abnormal within the terms of the Commissioner's Regulation. This Regulation was proposed November 11, 1955, and adopted June 11, 1956, by Treasury Decision 6182. The same arguments regarding the force and effect of the demolition Regulation (*Brief Supra* p. 14, 15) apply to this Regulation. While this Regulation did not exist under the 1939 Code, the principle it seeks to apply is not new.

The pattern of taxation in regard to depreciable property involves the writing-off of cost. A taxpayer estimates the useful life of property and its probable salvage value at the end of that life, and thereafter, until the situation changes proceeds to compute his annual depreciation on the basis of these assumptions. When the situation has so changed that the useful life of the property to the taxpayer has been redetermined, then a final adjustment of depreciation becomes necessary. Demolition is such a redetermination. See *Cosmopolitan Corporation* v. *Commissioner,* 1959 T.C. Memo 122; *Raymond L. Klinck* v. *Commissioner,* 11 T.C.M. 1224. Depreciation is to be determined according to circumstances as they are known to exist at the end of the subject year. *Rayville Coal Co.* v. *Commissioner,* 20 BTA 525, a decision in which the Com-

missioner acquiesced and *Sample-Durich Co.* v. *Commissioner,* 35 BTA 1186.

The trial court stated on this issue (Finding of Fact 11, R.I. 18):

> "When the buildings were demolished they had a useful life for a substantial number of years in the future, * * *."

The trial court has apparently confused useful life with physical or economic life. Physical or economic life is not the proper criteria for fixing depreciation; useful life is. *The Hertz Corporation* v. *U.S.*, 364 U.S. 122; *Massey Motors, et al.* v. *U.S.*, 364 U.S. 92.

There is no dispute that the buildings in question were in excellent physical shape, but this has nothing to do with Section 167 and useful life. It is the taxpayer's contention that the useful life of these buildings was redetermined in 1937. Treasury Regulation 1.167(b)-(0) provides as follows:

> "(a) * * * The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the year for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness for the depreciation claimed. Generally, depreciation deductions so claimed will be charged only where there is a clear and convincing basis for a charge."

Demolition is a clear and convincing basis for an adjustment to useful life. Under the theory of each tax year standing on its own, the adjustment must take place in the year of final determination of useful life. *C. Cohn* v. *U.S.*, 259 F.2d 371 (C.A. 6th).

In *H. A. Kuckenberg* v. *Commissioner,* 35 T.C. 473, a corporation made a liquidating distribution of its assets to its stockholders, who, in turn, transferred the

assets to their new partnership. A reappraisal of the assets by the partnership led to extended lives for assets. The Commissioner contended the corporation must, on its final return, use such extended lives. The Tax Court agreed and its reasoning was based on the fact that at the time the accountant prepared both the corporate and partnership returns, he knew the assets had a longer useful life than originally estimated in earlier corporate returns, and he should have made an adjustment extending the life. If such an adjustment is necessary when it suits the revenue, then it must be equally necessary when it does not.

From facts known at the end of 1957, taxpayer knew that the remaining useful life of this depreciable property was zero, and he was entitled to recover the balance of his cost basis in that year.

CONCLUSION

For the reasons stated, it is respectfully submitted that the decision of the trial court was erroneous and should be reversed.

Respectfully submitted,

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I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

DAVID W. RICHTER,
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APPENDIX A

STATUTES INVOLVED

Internal Revenue Code of 1954:

Sec. 165, LOSSES.

(a) GENERAL RULE – There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) AMOUNT OF DEDUCTION – For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) LIMITATION ON LOSSES OF INDIVIDUALS – In the the case of an individual, the deduction under sub-section (a) shall be limited to – (1) losses incurred in a trade or business. * * * (26 U.S.C. 1958 ed., Sec. 165)

Sec. 167. DEPRECIATION.

(a) GENERAL RULE – There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) – (1) of property used in the trade or business, or (2) of property held for the production of income.

* * *

(g) BASIS FOR DEPRECIATION – The basis on which exhaustion wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided

in section 1011 for the purpose of determining the gain on the sale or other disposition of such property. (26 U.S.C. 1958 ed., Sec. 167)

Sec. 7805. RULES AND REGULATIONS—

* * *

(b) RETROACTIVITY OF REGULATIONS OR RULINGS — The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect. (26 U.S.C. 1958 ed., Sec. 7805)

TREASURY REGULATIONS ON PROCEDURE AND ADMINISTRATION (1954 CODE):

Reg. §1.165-3 (T.D. 6445, filed 1-15-60) DEMOLITION OF BUILDINGS.

(a) *Intent to demolish formed at time of purchase.*

(1) Except as provided in subparagraph (2) of this paragraph, the following rule shall apply when, in the course of a trade or business or in a transaction entered into for profit, real property is purchased with the intention of demolishing either immediately or subsequently the building situated thereon: No deduction shall be allowed under section 165(a) on account of the demolition of the old buildings even though any demolition originally planned is subsequently deferred or abandoned. The entire basis of the property so purchased shall, notwithstanding the provisions of §1.167(a)-5, be allocated to the land only. Such basis shall be increased by the net cost of demolition or

decreased by the net proceeds from demolition.

(2) (i) If the property is purchased with the intention of demolishing the buildings and the buildings are used in a trade or business or held for the production of income before their demolition, a portion of the basis of the property may be allocated to such buildings and depreciated over the period during which they are so used or held. The fact that the taxpayer intends to demolish the buildings shall be taken into account in making the apportionment of basis between the land and buildings under §1.167(a)-5. In any event, the portion of the purchase price which may be allocated to the buildings shall not exceed the present value of the right to receive rentals from the buildings over the period of their intended use. The present value of such right shall be determined at the time that the buildings are first used in the trade or business or first held for the production of income. If the taxpayer does not rent the buildings, but uses them in his own trade or business or in the production of his income, the present value of such right shall be determined by reference to the rentals which could be realized during such period of intended use. The fact that the taxpayer intends to rent or use the buildings for a limited period before their demolition shall also be taken into account in computing the useful life in accordance with paragraph (b) of §1.167(a)-1.

(ii) Any portion of the purchase price which is allocated to the buildings in accordance with

this subparagraph shall not be included in the basis of the land computed under sub-paragraph (1) of this paragraph, and any portion of the basis of the buildings which has not been recovered through depreciation or otherwise at the time of the demolition of the buildings is allowable as a deduction under section 165.

(iii) The application of this subparagraph may be illustrated by the following example:

Example. In January, 1958, A purchased land and a building for $60,000 with the intention of demolishing the building. In the following April, A concludes that he will be unable to commence the construction of a proposed new building for a period of more than 3 years. Accordingly, on June 1, 1958, he leased the building for a period of 3 years at an annual rental of $1,200. A intends to demolish the building upon expiration of the lease. A may allocate a portion of the $60,000 basis of the property to the building to be depreciated over the 3-year period. That portion is equal to the present value of the right to receive $3,600 (3 times $1,200). Assuming that the present value of that right determined as of June 1, 1958, is $2,850, A may allocate that amount to the building and, if A files his return on the basis of a taxable year ending May 31, 1959, A may take a depreciation deduction with respect to such building of $950 for such taxable year. The basis of the land to A as determined under subparagraph (1) of this paragraph is reduced by $2,850. If on June 1, 1960, A ceases

to rent the building and demolishes it, the balance of the undepreciated portion allocated to the buildings, $950, may be deducted from gross income under section 165.

(3) The basis of any building acquired in replacement of the old buildings shall not include any part of the basis of the property originally purchased even though such part was, at the time of purchase, allocated to the buildings to be demolished for purposes of determining allowable depreciation for the period before demolition.

(b) *Intent to demolish formed subsquent to time of acquisition.*

(1) Except as provided in subparagraph (2) of this paragraph, the loss incurred in a trade or business or in a transaction entered into for profit and arising from a demolition of old buildings shall be allowed as a deduction under section 165(a) if the demolition occurs as a result of a plan formed subsequent to the acquisition of the buildings demolished. The amount of the loss shall be the adjusted basis of the buildings demolished increased by the net cost of demolition or decreased by the net proceeds from demolition. See paragraph (c) of §1.165-1 relating to amount deductible under section 165. The basis of any building acquired in replacement of old buildings shall not include any part of the basis of the property so demolished.

(2) If a lessor or lessee of real property demolishes the buildings situated thereon pursuant to the requirements of a lease or the

requirements of an agreement which resulted in a lease, no deduction shall be allowed to the lessor under section 165(a) on account of the demolition of the old buildings. However, the adjusted basis of the demolished buildings, increased by the net cost of demolition or decreased by the net proceeds from demolition, shall be considered as a part of the cost of the lease to be amortized over the term thereof.

* * *

Reg. §1.167(a)-8. RETIREMENTS –

(a) *Gains and Losses on Retirements*

For the purpose of this section the term "retirement" means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful life used in computing depreciation and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized,

the amount of such gain or loss, and the basis for determining gain or loss:

* * *

(3) Where an asset is permanently retired from use in the trade or business or in the production of income but is not disposed of by the taxpayer or physically abandoned (as, for example, when the asset is transferred to a supplies or scrap account) gain will not be recognized. In such a case loss will be recognized measured by the excess of the adjusted basis of the asset at the time of retirement over the estimated salvage value or over the fair market value at the time of such retirement if greater, but only if —

(i) The retirement is an abnormal retirement, or

(ii) The retirement is a normal retirement a single asset account (but see paragraph (d) of this section for special rule for item accounts), or

(iii) The retirement is a normal retirement from a multiple asset account in which the depreciation rate was based on the maximum expected life of the longest lived asset contained in the account.

* * *

(b) *Definition of normal and abnormal requirements.*

For the purpose of this section the determination of whether a retirement is normal or abnormal shall be made in the light of all the facts and circumstances. In general, a retire-

ment shall be considered a normal retirement unless the taxpayer can show that the withdrawal of the asset was due to a cause not contemplated in setting the applicable depreciation rate. For example, a retirement is considered normal if made within the range of years taken into consideration in fixing the depreciation rate and if the asset has reached a condition at which, in the normal course of events, the taxpayer customarily retires similar assets from use in his business. On the other hand, a retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

* * *

APPENDIX B

Table of Exhibits Pursuant to Rule 18(2)(b) as amended:

Exhibit	*Identified*	*Offered*	*Received*
1	18	18	18
2	21	21	22
A	61	61	62